



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
CHARLES S. HOWARD COMPANY }

Appearances:

For Appellant: Orville R. Vaughn, its Attorney.

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; James J. Arditto, Franchise Tax Counsel.

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Charles S. Howard Company to a proposed assessment of additional tax in the amount of \$186.40 for the taxable year ended December 31, 1938.

The appeal presents the same issue respecting the deductibility of legal expenses as was presented in the Appeal of Howard Automobile Company, this day decided by us. For the reasons set forth in our opinion in that matter, we conclude that the action of the Commissioner in disallowing the deduction was correct.

There is also presented herein for our consideration the propriety of the action of the Commissioner in disallowing as a deduction in 1937 an amount of \$825 received in that year from two of Appellant's lessees. The Commissioner regarded this sum as a part of taxable income for the year 1937 upon the grounds that it was received without restriction as to its disposition, use or enjoyment, and that it was a bonus received in consideration for executing a lease. He concluded, therefore, that it constituted income to the lessor for the year in which it was received. Appellant maintains its records and files its returns on the accrual basis. It contends that the amounts in question did not accrue in or constitute income for 1937, that they were treated as liabilities in its books, that they were paid and received as security for the faithful performance of the lessees' obligations under the leases, and that they were to be applied as rent during the final months of the term only if the lessees had faithfully complied with the terms of their leases.

The Appellant cites in support of its position only Clinton Hotel Realty Corporation v. Commissioner, 128 F. (2d) 968, and Aluminum Castings Company v. Routzahn, 282 U. S. 91. The latter is referred to only to uphold Appellant's position that its books

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of account were kept and its returns filed on an accrual basis. The Commissioner has not contended otherwise, however, so discussion of the matter is unnecessary.

The Clinton Realty case involved a payment by a lessee at the time of the execution of a lease to a lessor who kept his books on an accrual basis, the lease providing that the amount paid "shall be credited upon the rental for the last year of the term of this lease on the 3rd day of June, 1944, upon the terms and conditions hereinafter set forth." (emphasis added by the Court) The lease contained numerous terms and conditions and provided that the amount paid shall be considered as security for the payment of the rent and the performance of the terms and conditions of the lease by the lessee. It was held that in view of such terms and conditions the amount did not accrue as income at the time it was paid. The Court distinguished between a situation in which an amount is paid and received at the time of the execution of a lease as rent paid in advance and one in which the amount is paid and received as security with no present right or claim of full ownership in the lessor, although it was expected that it would be applied in payment of the last year's rent if nothing happened to prevent such application. The Court declared that the amount would be taxable when received in the first situation, but that it would not be present income in the second.

The provisions of the leases here in question support the position of the Commissioner that the rents were received without any restrictions as to their disposition. One of the leases (the parties have stipulated that the other leases are substantially the same in this respect) provides:

"Lessor acknowledges receipt from Lessee of the sum of SIX HUNDRED FIFTY DOLLARS (\$650.00) as an additional inducement and consideration for the execution by Lessor of this lease, which sum shall be and remain the property of Lessor, and Lessee agrees that such sum is paid solely as such consideration and for the purpose of obtaining this lease, and is an absolute payment to Lessor for that purpose. Lessor agrees that if Lessee shall faithfully perform all of the terms, covenants and conditions of this lease on his part to be performed during the term of this lease and until the first day of December, 1940, then and solely in consideration of such performance, there shall be deducted from the rental required to be paid to Lessor for the period from the date last above mentioned until the date of termination of this lease, the sum of SIX HUNDRED FIFTY DOLLARS (\$650.00) for each month during such period, anything herein contained to the contrary notwithstanding."

* The provisions of this lease are in our opinion distinguishable from those of the lease involved in the Clinton Hotel case. The lease here in question states that the sum was received by the lessor as an additional inducement and consideration for the

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execution of the lease by the lessor, that the sum shall be and remain the property of the lessor, that such sum is paid solely as such consideration and for the purpose of obtaining the lease and that it is an absolute payment to the lessor for that purpose. In the lease involved in the Clinton Hotel case the sum paid the lessor was always referred to as a "security" or "deposit" and the Court found that it was not received by the lessor with a present right or claim of full ownership.

Additional authority in support of the Commissioner's action is found in Astor Holding Co. v. Commissioner, 135 F. (2d) 47 and C. H. Mead Coal Co., 31 B.T.A. 190. In each case an amount received by a lessor at the time of the execution of the lease, the lessor in each case reporting on an accrual basis, was held to constitute income in the year of receipt since the lessor had an absolute right to the amount received and there were no restrictions as to its use or disposition of such amount. Although it is not set forth in the opinion of the Court in the Astor case that the taxpayer reported on the accrual basis, it is stated that such was the case in the decision of the Board of Tax Appeals (B.T.A. Memo Op., Dkt. 104961, July 30, 1942), which was affirmed by the Court. It should also be observed that the Circuit Court of Appeals in this case distinguished the Clinton Hotel case, which had been decided the preceding year by the same Court, in the same way in which we have distinguished that case from the present matter, that is, on the basis that the amount paid the lessor was received by him under the lease with a present right of full ownership rather than merely as a security or deposit.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Charles S. Howard Company to a proposed assessment of additional tax in the amount of \$186.40 for the taxable year ended December 31, 1938, pursuant to Chapter 13, Statutes of 1929 as amended, be and the same is hereby sustained.

Done at Sacramento, California, this 11th day of May, 1944, by the State Board of Equalization.

R. E. Collins, Chairman
Wm. G. Bonelli, Member
Geo. R. Reilly, Member
Harry B. Riley, Member
J. H. Quinn, Member

ATTEST: Dixwell L. Pierce, Secretary